No. 17,938

In the United States Court of Appeals for the Ninth Circuit

CASY O'BRIEN and DOROTHA O'BRIEN, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decisions of the Tax Court of the United States

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BRIEF FOR THE RESPONDENT

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INDEX

CITATIONS

Cases:

Statutes: Page

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 126-139) are reported at 36 T.C. 957.

JURISDICTION

The petition for review (R. 154) in this case involves federal income tax for the calendar years 1955, 1956, and 1957 in the amounts of $975.29, $1,083.62, and $1,149.26, respectively. (R. 6, 11, 19.) On July 29, 1958, the Commissioner of Internal Revenue mailed to the taxpayer notices of defi-

ciency for the taxable years 1955 and 1956. (R. 6-10, 11-14.) Within ninety days thereafter and on October 23, 1958, the taxpayer filed a petition with the Tax Court for a redetermination of these deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. (R. 1-14.) On January 12, 1960, the Commissioner mailed to the taxpayer a notice of deficiency for the taxable year 1957. (R. 19-21.) Within ninety days thereafter and on April 11, 1960, the taxpayer filed a petition with the Tax Court for a redetermination of the deficiency for the taxable year 1957 under the provisions of Section 6213 of the Internal Revenue Code of 1954. (R. 16-21.) By order dated June 8, 1960, the two cases, Tax Court Docket Nos. 77,290 and 86,023, were consolidated. (R. 23.) The decisions of the Tax Court were entered on December 15, 1961. (R. 150, 151.) The cases are brought to this Court by a petition for review filed February 19, 1962. (R. 154.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

In computing his net operating loss for 1952 under Section 122(a) of the Internal Revenue Code of 1939, for carry-over purposes to the taxable years 1955 through 1957, may the taxpayer deduct a $33,451.67 judgment obtained against him in 1952 by four insurance companies when he did not pay any part of the judgment in 1952 and the judgment was based upon false and fraudulent statements he made in his insurance claim for a fire loss?

STATUTES INVOLVED

The statutes are set forth in the Appendix, *infra.*

STATEMENT

The facts, as stipulated (R. 25-29) and as found by the Tax Court (R. 126-133), may be stated as follows:

Casy O'Brien (hereinafter called taxpayer)[1] operated, as a sole proprietor, Casy's Feed and Seed Store in Redding, California. On July 17, 1949, a fire destroyed $27,853.23 worth of taxpayer's store's inventory and stock in trade. On or about August 3, 1949, taxpayer filed, with his four insurance companies, claims for the loss totalling $33,451.67—$5,598.44 more than the actual fire damage. (R. 126-127.) In order to support the $5,598.44 difference between the actual and claimed loss, taxpayer prepared and submitted to the insurance companies seven false and fraudulent scale tags or weight certificates purporting to show that taxpayer had purchased barley, wheat, and oats, as follows (R. 127):

[1] Although joint returns were filed by taxpayer and his wife, for convenience this brief will refer to Mr. O'Brien as the sole taxpayer.

Tag or Certificate No.	Commodity	Amount of Claimed Purchase
8091	Wheat	$1,579.03
8183	Barley	908.56
8184	Barley	913.48
8185	Wheat	527.80
8186	Barley	859.57
8187	Wheat	378.00
8188	Oats	432.00
Total		$5,598.44

The insurance companies paid taxpayer the $33,-451.67 that he claimed due to him because of the fire loss; $30,106.51 was paid in 1949 and the remaining $3,345.16 was paid in 1950. (R. 127.) Subsequently, taxpayer's fraud was discovered and he was charged in a California criminal proceeding with violation of Section 556 of the Insurance Code of California, relating to the presentation of false and fraudulent claims of loss to insurers. (R. 128-129.) On June 11, 1951, taxpayer pleaded guilty to 11 violations of Section 556; taxpayer was then convicted and sentenced to prison for the statutory term. (R. 129; Stip. par. 8, R. 27-28.)

On July 5, 1951, the four insurance companies commenced suit against taxpayer for the $33,451.67 paid him. (R. 129.) The insurance companies' cause of action was based upon the following term contained in each insurance policy (R. 129)—

> This entire policy shall be void, (a) if the insured has concealed or misrepresented any material fact or circumstances concerning this insurance or the subject thereof; or (b) in case

> of any fraud or false swearing by the insured touching any matter relating to this insurance or the subject thereof, whether before or after a loss.

This provision was alleged to be applicable by reason of taxpayer's presentation of the false and fraudulent certificates to the insurance companies. (R. 129.) On January 16, 1952, the California Superior Court granted the insurance companies' motion for summary judgment, stating in part (R. 130; see Ex. 5-E):

> Under Section 437c of the Code of Civil Procedure the motion for a summary judgment here must be granted, although there are some denials set forth in the answer, taking into consideration the affidavits on file with the documentary evidence consisting of the proceedings in People vs. Casy O'Brien in this same Court, it is plain that there is no meritorious defense to the complaint in this action.
>
> In fact, counsel for defendants practically concedes that as to the amount to which the various plaintiffs were defrauded by the defendant, the motion might be good and the main basis of argument is whether the plaintiffs can recover the full amount of their various insurance policy totals because of the facts alleged in the complaint; although it seems to be a harsh rule, apparently such is the case. The policies were voided by the action of the defendant for which he was adjudged guilty criminally on his own plea and said policies being voided and wiped out, the defendant's insurance companies were not obligated to pay one cent on any of them, and

> having made such payments before discovering the fraud to which they had been subjected, they are now entitled under their complaint in this action to recover the full amount thereof, if possible.

On January 28, 1952, judgment was entered for the insurance companies. The judgment was for the total amount prayed for — $33,451.67 — plus court costs of $18 and interest of 7% running from the dates of the payments to taxpayer. (R. 130.)

On January 30, 1953, taxpayer and the insurance companies agreed to the following compromise of the $33,451.67 judgment: Taxpayer was to pay $7,500, 4,500 down and 12 quarterly $250 payments beginning February 1, 1953; alternatively, taxpayer could pay $6,750 instead of $7,500 if the $6,750 was paid on or before February 1, 1954. Taxpayer paid the $4,-500 down but did not make any of the quarterly payments. In 1956, taxpayer paid $500 more to the insurance companies in consideration of the companies' release of a judgment lien against certain of taxpayer's properties that taxpayer wished to convey to third parties. In May, 1957, the statute of limitations was about to run out on the insurance companies' judgment; thereupon, the judgment was renewed. Subsequently, in 1958, the insurance companies entered a satisfaction of the judgment upon taxpayer's payment to them of $3,000. (R. 130-131.)

On taxpayer's income tax return for 1952, there was included in the amount deducted as "other busi-

ness expenses," on line 21 of Schedule C, $38,141.51 [2] which was described as "Judgment in Superior Court —Shasta County." In his tax returns filed for the succeeding years 1953 through 1957, taxpayer claimed net operating loss carry-over deductions, resulting in major part from the judgment claimed on taxpayer's 1952 return in respect of the judgment recovered against taxpayer by the insurance companies. The Commissioner, in his statutory notice of deficiency for 1955 (the first taxable year here involved), stated that the deduction of $38,141.51 claimed on the 1952 return was allowable only to the extent of $8,000. (R. 131-132.) The Commissioner explained (R. 132):

> The loss claimed in the taxable year 1952 in the amount of $38,141.51 from a judgment assessed by insurance companies on January 28, 1952, has been determined to be $8,000.00. It is held that the fair market value of the judgment be a total of the cash payments of $4,500.00, periodic payments aggregating $3,000.00 and an additional $500.00 paid in cash. Income has therefore been increased by $30,141.51.

The Commissioner claimed that no portion of the net operating loss remained unabsorbed at the beginning of the taxable year here involved; accordingly, the net operating loss carry-over deductions claimed for 1955, 1956, and 1957 were disallowed. (R. 132-133.)

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[2] The amount of $38,141.51 was apparently composed of (1) the $33,451.67 judgment, (2) interest of $4,681.84, and (3) court costs of $18. (R. 132.)

In the Tax Court proceeding, however, the Commissioner (departing from his position in the notice of deficiency that the judgment loss was deductible in 1952 to the extent of $8,000) argued that no loss at all was deductible for 1952. (R. 133.) The Tax Court agreed with the Commissioner's position as to the $33,451.67 judgment and $18 court costs, stating: "The allowance of such a deduction would frustrate the sharply defined public policy of California against making false claims of loss, by removing some of the "sting" from the consequence of petitioner's [taxpayer's] wrongdoing." (R. 137.) However, the Tax Court held the interest element—$4,681.84—deductible. (R. 139.) The Tax Court then concluded (R. 139):

> However, as we have found as a fact, the respondent in computing the amount of the deficiencies here involved allowed the petitioner a 1952 deduction for his claimed judgment loss in the amount of $8,000, which is in excess of the interest element of $4,681.84; and notwithstanding that respondent later changed his position, he has not sought to withdraw the benefit of such allowance. Thus, petitioner has already received a greater benefit than that to which he is entitled.

SUMMARY OF ARGUMENT

In 1949 and 1950 the taxpayer received insurance proceeds in the amount of $33,451.67, covering the fire damage to his feed and seed inventory and stock in trade. In 1952 it was discovered that he had pre-

sented false and fraudulent claims to the insurance companies; he was convicted for the crime and, in a civil proceeding filed against him by the insurance companies, the insurance policies were held to have been voided by his false and fraudulent representations and judgment was entered in favor of the insurance companies for the amount of the insurance proceeds they had previously paid him. Although he repaid none of the insurance proceeds in 1952 and never even subsequently paid more than $8,000, he claims a deduction in 1952 for the entire amount of the judgment on the ground that he was on the accrual basis and therefore entitled to deduct the insurance proceeds in the year his obligation to repay became evidenced by the judgment. On the basis of the resulting increase in his net operating loss in 1952, he claims carry-over deductions of that net operating loss to the taxable years 1955 through 1957.

1. The taxpayer is not entitled to the 1952 deduction he claims as a basis for carry-over deductions in the taxable years, and in that connection it is immaterial whether he was on the cash or accrual basis. The case involves money wrongfully received and to be taken into account in the years of receipt under the claim of right doctrine. He properly took the insurance proceeds into account in his 1949 and 1950 returns by not claiming a fire loss deduction. The proper year for offsetting deductions for the $33,451.67 is when the wrongfully received money is actually repaid. Since he made no repayment in 1952, he was not entitled to a deduction in any amount in that year. Moreover, he has been allowed

the benefit of his payment in subsequent years of a total of $8,000, since the Commissioner originally allowed him to deduct that amount in 1952. To allow him a greater deduction for 1952 (or any other year) would be to reward him for violating state law and thus, as the Tax Court held, frustrate state policy.

2. The $33,451.67 judgment is not deductible in computing the taxpayer's 1952 net operating loss for another reason. Under Section 122(a) and (d) the net operating loss is computed by excluding deductions which are allowed by law but not attributable to the trade or business (although such deductions may be applied against other income). The 1952 judgment was attributable to false and fraudulent statements made by the taxpayer in his insurance claim, rather than to the fire connected with his business, and the judgment therefore was not attributable to his trade or business.

ARGUMENT

The Tax Court Correctly Held That the Taxpayer Is Not Entitled To a Deduction In 1952 In Excess of $8,000 By Virtue of the Judgment Rendered Against Him In That Year and That He Therefore Had No Net Operating Loss In 1952 Under Section 122(a) of the Internal Revenue Code of 1939 To Carry Over To and Deduct In the Taxable Years 1955 Through 1957

A. *The 1952 judgment is not deductible because it was not paid in 1952*

In 1949 and 1950 the taxpayer received a total of $33,451.67 from insurance companies on his claims for a loss due to a fire which destroyed the inventory and stock in trade of his feed and seed store. In

those years he had no loss from fire and did not claim one, since the loss was fully compensated for by insurance and therefore not deductible. (Section 23(e) of the Internal Revenue Code of 1939, Appendix, *infra.*) Two years later he was charged and convicted in a criminal proceeding relating to presentation of false and fraudulent claims of loss and, in a civil proceeding instituted by the insurance companies, the insurance policies were held to have been voided by the taxpayer's fraud and judgment was entered in favor of the insurance companies for the $33,-451.67, which they had previously paid the taxpayer as insurance proceeds. The taxpayer did not pay any part of the judgment in 1952. On January 30, 1953, prior to the filing of his 1952 return, he entered into a compromise agreement with the insurance companies under which he was to pay a total of $7,500, or $6,750, by January 1, 1954, in place of the $33,-451.67 amount of the judgment. As it turned out, a total of $8,000 was paid by or on his behalf in years subsequent to 1952, and in 1958 the insurance companies entered a satisfaction of the judgment. Thus, the taxpayer retained $25,451.67 of the amount paid to him as insurance proceeds.

Nevertheless, the taxpayer has contended that the entire $33,451.67 (plus an additional amount apparently composed of $4,681.34 in interest on the judgment sum and $18 in court costs, and thus a total of $38,141.51) was deductible in 1952 as a business expense or loss; that the deduction of that amount resulted in a net operating loss in 1952;

and that the net operating loss may be carried forward and deducted in the taxable years 1955 through 1957. The Commissioner allowed the taxpayer a deduction of $8,000 in 1952 and, as a result of this and other adjustments not in issue, determined that no portion of the taxpayer's 1952 net operating loss remained unabsorbed at the beginning of the first taxable year (1955). Accordingly, while the issue is as to the propriety of claimed net operating loss carryover deductions in 1955 through 1957, the answer thereto depends upon the amount of the taxpayer's net operating loss in 1952, which, in the Tax Court, in turn depended upon whether he was in that year entitled to a deduction in excess of $8,000 because of the judgment entered against him in that year in favor of the insurance companies.

The Tax Court held that no part of the $33,451.67 judgment or $18 in court costs were deductible by the taxpayer in 1952. However, noting that the taxpayer was apparently claiming a deduction in 1952 for $4,681.84 representing interest on the principal sum, the Tax Court held that this amount was deductible but that, since the Commissioner had allowed an $8,000 deduction in 1952, the taxpayer had already received a greater benefit than that to which he is entitled. (R. 139.) In the Rule 50 computation the $8,000 deduction was reduced to $4,681.84 (see R. 144), but this of course did not change the fact that the taxpayer's net operating loss for 1952 was offset against income in 1953 and 1954 and that there therefore was no 1952 net operating loss to carryover to

and deduct in the taxable years 1955 through 1957.[4] Nor did it change the fact that for the closed year 1953 and 1954 effect had been given to the $8,000 deduction allowed by the Commissioner for 1952.

The holding of the Tax Court (where the taxpayer was represented by counsel) that the $33,451.67 judgment was not deductible in 1952 was based on the ground that allowance of the claimed deduction "would frustrate the sharply defined public policy of California * * * by removing some of the 'sting' from the consequences of petitioner's [taxpayers'] wrongdoing." (R. 137.) We believe that frustration of state policy is a proper basis for denying the taxpayer's claim (cf., *Tank Truck Rentals* v. *Commissioner*, 350 U.S. 30; *Hoover Express Co.* v. *United States*, 356 U.S. 38) but for a more precise reason, i.e., the taxpayer had no loss in 1952, no loss in any succeeding year in excess of $8,000, and therefore to allow him a deduction in 1952 for the entire $33,451.67 would be to *reward* him for having violated state law. The 1952 judgment and the resulting obligation on the part of the taxpayer to make restitution of the insurance proceeds did not of itself frustrate state policy, but to allow the deduction he claimed on the basis of that judgment would. In brief, the correctness of the Tax Court's basis for

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[4] With an $8,000 deduction in 1952 and a carry-over of that amount to 1953 and 1954, the deduction offset all of the taxpayer's income in 1953 and all but $34.42 of his 1954 income of $6,098.47. With a $4,681.84 deduction in 1952 and a carry-over of that amount of 1953 and 1954, the deduction offset all of the taxpayer's income in 1953 and offset $2,745.89 of his 1954 income of $6,098.47. (See R. 148.)

decision turns upon whether the taxpayer had a loss in 1952 in excess of $8,000 (an amount which would all be absorbed prior to the taxable years). The answer requires consideration of fundamental precepts in the light of the facts of the case, is plainly in the negative, and thus provides incontrovertible support for the Tax Court's decision even independently of the frustration of state policy which results if the taxpayer is allowed the claimed deduction.[5]

It is apparent, as the Tax Court stated (R. 135), that the taxpayer had no loss in 1952 from the fire which destroyed his inventory and stock in trade. In the first place, since he had presented false and fraudulent scale tags and weight certificates purporting to show purchases of grain totalling a claimed $5,598.44 (see R. 127) and the insurance companies had paid him a total of $33,345.67, including the amount of the fraudulent claims, only the difference, or $27,747.23, could represent a loss traceable to the

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[5] In his 1952 income tax return the taxpayer claimed a deduction of $38,141.51 under "other business expenses" (R. 131-132), but in the Tax Court argued only for deduction of a "judgment loss" (R. 133). The amount of the judgment (plus interest and court costs) plainly was not deductible under Code Section 23(a)(1)(A) (Appendix, *infra*) as being an ordinary and necessary expense incurred by the taxpayer in carrying on his trade or business. The judgment liability was not a *business* expense, because it had its origin not in the fire loss but in the taxpayer's fraudulent action which nullified the insurance policies covering the fire loss and, for the same reason, was neither an "ordinary" nor "necessary" expense incurred in the taxpayer's business. Cf. *United States* v. *Gilmore,* 372 U.S. 39.

fire. Secondly, that loss was fully compensated for by the insurance companies' payment to the taxpayer of the $33,345.67 in 1949 and 1950 and, if he later sustained a loss, it was not because of the fire but because he had made false and fraudulent statements to the insurance companies in his fire loss claim. In 1952 those fraudulent statements were held to render the insurance policies void. This meant that the fire was not covered by insurance and that the taxpayer had received $33,345.67 to which he was not entitled. But the judgment in favor of the insurance companies merely entitled them to collect the $33,345.67 from the taxpayer if they could; it did not give them back their $33,345.67. And, until the taxpayer disgorged the $33,345.67, he had no loss either from the fire or from making fraudulent statements to the insurance companies. Only the potential for a deduction in the amount of $33,345.67 (or a larger sum, including interest) existed—the possibility that he would pay the judgment in that amount, which would cancel out his prior receipt of the $33,345.67.

The taxpayer's argument in the Tax Court, and apparently also in this Court (see Br. 6-7), was that he was on the accrual basis of reporting his income and that the judgment, representing an obligation to repay the insurance companies, established his loss. The Tax Court made no finding as to whether he was on the cash or accrual basis.

If he was on the cash basis, his claim to a deduction in 1952 requires little discussion. It is axiomatic that a cash basis taxpayer has no right to a

deduction in the absence of actual payment of the item for which a deduction is claimed; it is not enough that an obligation to pay may have arisen. The taxpayer made no payment in 1952 on the judgment and therefore had no loss in 1952 as a result of the judgment (although the Commissioner allowed him an $8,000 deduction in 1952). As a cash basis taxpayer, the taxpayer would be entitled to deductions in the subsequent years for amounts paid on the judgment, but he has not claimed such deductions and they would not help him for the taxable years 1955 through 1957. He paid $4,500 on the judgment in 1953, but that amount would be cancelled out by deduction against 1953 and 1954 income.[6] He paid $500 in 1956, one of the taxable years, but that amount, according to the Tax Court's finding (R. 131), was paid "in consideration for their [the insurance companies'] release of the judgment lien for certain property which petitioner and his wife desired to sell to third parties" and was therefore really a capital investment rather than a deductible item. The final $3,000 was paid in 1958, which is after the taxable years involved here.

The same result obtains for the taxable years, although for a different reason, if the taxpayer was on

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[6] In 1952 the taxpayer had a business loss of $2,513.91 over and above any loss from the judgment. If his $4,500 payment in 1953 is deducted in that year, when he otherwise had income of $1,772.10, he had a total loss of $5,241.81 in 1952 and 1953 and this would be offset against his 1954 income of $6,098.47. Thus, the $4,500 deduction in 1953 would be absorbed before the taxable years.

the accrual basis. This is not a case involving the accrual of income and deductions on the basis of the mere right to receive income and the obligation to pay expenses, respectively. Nor does the case involve a question as to when the taxpayer is entitled to a deduction for a fire loss. The taxpayer was compensated for the fire loss in 1949 and 1950 and that transaction is closed. The only question is whether and when the taxpayer is entitled to a deduction because of his obligation, evidenced by the judgment rendered against him in 1952, to repay the insurance proceeds to the insurance companies. In other words, the question is not as to when a loss accrued (for the taxpayer had no loss as such), but as to when a deduction may be taken because of an obligation to repay money which the taxpayer actually received but was not entitled to receive.

The answer lies in what may, for present purposes, be called an exception as to accrual basis taxpayers, i.e., the time when a deduction is proper for money which has been taken into account for tax purposes under the claim of right doctrine "now deeply rooted in the federal tax system" (*United States* v. *Lewis*, 340 U.S. 590, 592). That doctrine, as first stated in *North American Oil* v. *Burnet*, 286 U.S. 417, 424, is that "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." The doctrine has been applied by the Supreme

Court to the net profits received from oil land while title to the land was still in dispute (*North American Oil* v. *Burnet, supra*), to a bonus which had been improperly computed (*United States* v. *Lewis, supra*), to excessive compensation leading to transferee liability (*Healy* v. *Commissioner*, 345 U.S. 278), and to amounts received illegally through embezzlement (*James* v. *United States*, 366 U.S. 213). The doctrine is not limited to money constituting earnings, as distinguished from money whose receipt compensates for a loss and therefore precludes the taking of a loss deduction. As stated in *Healy* v. *Commissioner*, *supra*, p. 282, "There is a claim of right when *funds* are received and treated by a taxpayer as belonging to him. The fact that subsequently the claim is found to be invalid by a court does not change the fact that the claim did exist" (italics supplied). And in *James* the funds involved consisted of embezzled funds, which obviously were not earnings as to the embezzler. In the present case, as in *James* (p. 216), the taxpayer "obtained the money by means of a criminal act * * *" and the important fact "is that the right to recoupment exists" (p. 217). The present taxpayer therefore correctly took the insurance proceeds into account in reporting his income in 1949 and 1950, when he received the insurance proceeds.

But, consistently with the rationale of the claim of right doctrine that the money wrongfully or mistakenly received is to be taken into account for tax purposes in the year of receipt, the taxpayer is entitled to a deduction in respect of the insurance proceeds only when they are actually repaid, not when the

obligation to repay accrued. As a matter of fact, the obligation to repay, on which the taxpayer has based his accrual argument, arose not in 1952, when the judgment against him was entered, but at the time he fraudulently received the insurance proceeds. The only reason he may be entitled to a deduction at all (irrespective of the proper year or years) is that he properly took the insurance proceeds into consideration in his 1949 and 1950 tax returns, as covering what, but for the compensating insurance proceeds, would have been a fire loss. For tax purposes, he is entitled to offset his receipt of the insurance proceeds if there is a basis for doing so. But the fact that in 1952 his fraud was discovered and reduced to a judgment requiring repayment of the amount of the insurance proceeds had no affect upon his income situation for that year. He still had the money. Until he disgorged it, he could not properly claim a deduction of any kind. He could only claim a deduction based upon a reduction in his income and there could be no such reduction in his income until he actually repaid the insurance proceeds. Accordingly, in 1952 there was nothing to support a deduction. As stated in the *James* case (p. 220):

> Just as the honest taxpayer may deduct an amount repaid in *the year in which the repayment is made*, the Government points out that, "*if, when, and to the extent that the victim recovers back the misappropriated funds*, there is of course a reduction in the embezzler's income." (Italics supplied.)

See also, *North American Oil* v. *Burnet, supra,* p. 424; *Healy* v. *Commissioner, supra,* p. 284.

The reason a taxpayer on the accrual basis is normally entitled to deductions in the year his obligation to pay accrues is that his income is also reported on a similar basis, i.e., when the right to receive accrues. It is assumed both that the income will be received and that the obligations will be paid. No such assumption can be made in relation to funds wrongfully or mistakenly received. First, there would be a contradiction in principle if the reporting of the income were required, as it is, merely because of its actual receipt under a claim of right, and if a deduction were then allowed for the same funds on some basis other than their actual restitution. Secondly, it is totally unrealistic, as a practical matter, to assume that wrongfully or mistakenly obtained funds will be repaid merely because the obligation of repayment exists. To allow a deduction although the funds have not been repaid and may never be repaid is to reward the taxpayer for his wrongful act. The tax laws permit no such anomalous result.

B. ***The 1952 judgment is not deductible because it was not attributable to the taxpayer's trade or business***

Code Section 122(a) (Appendix, *infra*) defines the term "net operating loss" as meaning "the excess of the deductions allowed by this chapter over the gross income, with the exceptions * * * provided in subsection (d)." Subsection (d) states that "Deductions otherwise allowed by law not attributable to

the operation of a trade or business regularly carried on by the taxpayer shall * * * be allowed only to the extent of the amount of the gross income not derived from such trade or business." It does not appear that the taxpayer had any income in 1952 which would be classified as nonbusiness income. Accordingly, the 1952 judgment provides no basis for a deduction in computing his net operating in 1952 if the judgment was "not attributable" to his trade or business.

We recognize that the judgment had a relation to his business in the sense that, if the fire had not occurred, he would never have filed false and fraudulent insurance claims and there would never have been any judgment against him. But the real reason for the judgment was not the fire. He was fully compensated for that. The judgment was occasioned solely be the false and fraudulent claims he made to the insurance companies, and these were no part of his business. We therefore believe that, for this additional reason, the taxpayer is not entitled to the deduction he claims in 1952.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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May, 1963

CERTIFICATE

It is hereby certified that counsel for the respondent has examined the provisions of Rules 18 and 19 of this Court and that in his opinion the foregoing brief conforms to all requirements.

Dated:.....day of....., 1963.

Attorney

APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *.

* * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *.

* * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the

time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 122 [as added by Sec. 211(b), Revenue Act of 1939, c. 247, 53 Stat. 862]. NET OPERATING LOSS DEDUCTION.

(a) [as amended by Sec. 105(e)(3)(A), Revenue Act of 1942, *supra*] *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) [as amended by Sec. 215(a), Revenue Act of 1950, c. 994, 64 Stat. 906] *Amount of Carry-Back and Carry-Over.*—

(1) *Net operating loss carry-back.*—

* * * *

(B) *Loss for Taxable Year Beginning After 1949.*—If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for the preceding taxable year.

(2) *Net operating loss carry-over.*—

* * * *

(B) *Loss for Taxable Year Beginning After 1949.*—If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating

loss, such net operating loss shall be a net operating loss carry-over for each of the five succeeding taxable years, except that the carry-over in the case of each such succeeding taxable year (other than the first succeeding taxable year) shall be the excess, if any, of the amount of such net operating loss over the sum of the net income for each of the intervening years computed—

(c) [as amended by Sec. 105(e)(3)(B) and Sec. 153(b), Revenue Act of 1942, *supra*, and Sec. 121(g)(2), Revenue Act of 1950, *supra*] *Amount of Net Operating Loss Deduction.*—The amount of the net operating loss deduction shall be the aggregate of the net operating loss carry-overs and of the net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d) (1), (2), (3), and (4)) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation, the normal-tax net income (computed without such deduction and without the credit provided in section 26(h)(i)).

(d) *Exceptions, Additions, and Limitations.*—The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

* * * *

(5) [as amended by Sec. 344(a), Revenue Act of 1951, c. 521, 65 Stat. 452] Deductions otherwise allowed by law not attribu-

table to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions, additions, and limitation specified in paragraphs (1) to (4) of this subsection. This paragraph shall not apply with respect to deductions allowable for losses sustained after December 31, 1950, in respect of property, if the losses arise from fire, storm, shipwreck, or other casualty, or from theft.

* * * *

(26 U.S.C. 1952 ed., Sec. 122.)

Insurance Code, 42 West's Annotated California Codes:

Sec. 556. *False or fraudulent claim; penalty.* It is unlawful to:

(a) Present or cause to be presented any false or fraudulent claim for the payment of a loss under a contract of insurance.

(b) Prepare, make, or subscribe any writing, with intent to present or use the same, or to allow it to be presented or used in support of any such claim.

Every person who violates any provision of this section is punishable by imprisonment in the State prison not exceeding three years, or by fine not exceeding one thousand dollars, or by both.

Penal Code, 47 West's Annotated California Codes:

Sec. 16. *Crimes; kinds*

CRIMES, HOW DEFINED. Crimes are divided into:

1. Felonies; and
2. Misdemeanors.

Sec. 17. *Felonies and misdemeanors defined; offense punishable as either felony or misdemeanor; commitment to youth authority*

A felony is a crime which is punishable with death or by imprisonment in the state prison. Every other crime is a misdemeanor. When a crime, punishable by imprisonment in the state prison, is also punishable by fine or imprisonment in a county jail, in the discretion of the court, it shall be deemed a misdemeanor for all purposes after a judgment imposing a punishment other than imprisonment in the state prison. * * *

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